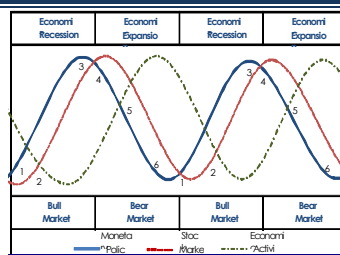


The Financial Commentator

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A GUIDE TO
FEDERAL RESERVE
MONETARY POLICY,
THE ECONOMY, AND
FINANCIAL MARKETS
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Newsletter – March 25, 2007

FEDERAL RESERVE

In last November's newsletter I discussed how much more transparent the Federal Reserve has become over the last decade in communicating monetary policy. Although this process was initially spurred by members of Congress who felt the unelected members of the Federal Reserve held more sway over the lives of ordinary Americans than Congress, the Federal Reserve has come to believe increased transparency has reduced volatility in the financial markets.

Since I don't get to vote at FOMC meetings, I've always felt, for me and the readers of this monthly missive, that it is far more important to understand what the Fed members are really saying about policy than for me to inject my personal opinion about whether their assessment is correct. One would think the Fed's willingness to share its views, and those of individual members more openly would lead to more accuracy in forecasting what the Fed was likely to do and when. Ironically, that's not true. As I pointed out last November, the majority of economists and financial experts expected the Federal Reserve to lower the Federal Funds rate at the March meeting. The Federal Funds Futures market in early December had pegged the probability of a rate cut in March at 74%. As I wrote in November's letter, "If the markets have indeed misread the Federal Reserve's take on the economy and inflation, the recent rally in the bond market will be reversed, and the recent surge in bearishness toward the Dollar will not be rewarded. As I've said since August, the Fed is going to keep the Federal Funds rate at 5.25% for many months." In the following weeks, bond yields rose from under 4.60% to 4.90%, and the Dollar rallied from under 83.00 to 85.17. Obviously, the Fed didn't lower their policy rate last week, but they did change their post meeting statement.

Within seconds of the release of the FOMC statement last week, financial markets concluded the Federal Reserve had changed the future direction of policy to a neutral bias, after maintaining a bias toward raising rates since last summer. On CNBC, Pimco's Bill Gross, noted a few minutes after the FOMC statement was released that in 2000 the Federal Reserve had lowered interest rates one month after going to a neutral policy. The suggestion, obviously, is that the Fed very well may cut rates next month. Pimco manages more than \$600 billion in bonds, and modestly reminds viewers that it is the authority on bonds.

Bill Gross is a very bright fellow and I only mention his comment since there is a fairly large contingency who share his view. The only questions worth asking, though, are whether the Fed

The Financial Commentator

Newsletter – March 25, 2007

did move policy to neutral, and how likely is the Fed to cut rates in the next 30-45 days. Rather than trying to be an interpreter for the Fed, I'll let their own words speak for them.

This is the FOMC policy statement after their May 4, 2004 meeting. “The committee perceives the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. Similarly, the risks to the goal of price stability have moved into balance.” In this statement, the Fed is clearly placing the outlook for both economic growth and inflation on an equal footing and noting that both are in good shape. This is a neutral policy stance. Now let's compare the Fed's assessment of inflation and economic growth from its January 31 statement and March 21, 2007 statement. In January, inflation was described as follows. “Readings on core inflation have improved modestly in recent months, and inflation pressures seem likely to moderate over time. However, the high level of resource utilization has the potential to sustain inflation pressures.” Last week they said this about inflation. “Recent reading on core inflation have been somewhat elevated. Although inflation pressures seem likely to moderate over time, the high level of resource utilization has the potential to sustain those pressures.” The March statement on inflation is certainly stronger than the January comments. It shows they are uncomfortable with the recent level of inflation, since they described it as “somewhat elevated.” And although both statements express the Fed's view that “inflation pressures seem likely to moderate overtime”, the March statement is clearly less confident than they were previously. In January, the Fed almost casually noted, “The committee judges that some inflation risks remain.” The March statement reflects more concern. “The committee's predominant policy concern remains the risk that inflation will fail to moderate as expected.”

The Fed would not emphasize their concern that inflation may not fulfill their forecast of moderating, at the same time they are shifting policy to neutral. ***When monetary policy is neutral, there are no predominant concerns.*** At a minimum, they are suggesting that a moderation in inflation may take more time than they previously expected. This suggests the notion that the Fed might lower their policy rate within the next 30-45 days is not a good bet.

Given this analysis, how could the markets have concluded that the Federal Reserve had adopted a neutral policy, and might possibly cut rates soon? When a teenager asks if he can have the car next Friday night, and the parents say, “Yes, but you have to be home by 11 pm”, when does the teenager stop listening? He hears the work yes, and that's it! Sometimes the analysis by economists and traders is almost that in depth. In January, the Fed's statement included the phrase, “The extent and timing of any additional firming that may be needed to address inflation risks will depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.” In March, the Fed dropped the phrase “the extent and timing of any additional firming that may be needed to address inflation risks”, and instead merely stated “future policy adjustments.” Clearly, this change represents a softening in the Fed's previous bias toward raising rates. It does not though, represent a neutral bias, especially when the Fed's

The Financial Commentator

Newsletter – March 25, 2007

assessment of inflation is factored into the analysis. But hey, Dad said I could have the car Friday night!

The reaction of the markets during the week as a whole is somewhat illuminating. The FOMC statement was released just after 2:15 pm EST on Wednesday. Within minutes, gold rallied, the Dollar fell, short and long-term Treasury bond yields declined, and stocks soared, as some of the 10% increase in short positions added in March on the NYSE were covered. Comparing the Tuesday and Friday closing levels of each market, indicates that many market participants were reconsidering whether the knee-jerk response on Wednesday was correct. Gold finished on Friday at \$656.70, down from \$657.40 on Tuesday. Ten-year Treasury yields rose from 6.57% on Tuesday to 6.62% on Friday, and the Dollar edged up from 82.81 to 83.00. Only stocks held up, as the S&P closed the week at 1436.11, up from 1410.94 on Tuesday. This suggests stocks are likely to retrace last Wednesday's post FOMC statement rally.

In January, the Fed's assessment of economic growth in coming quarters was straightforward. "Overall, the economy seems likely to expand at a moderate pace over coming quarters." Although the Fed acknowledged "recent indicators have been mixed," they also reiterated their January forecast, "The economy seems likely to expand at a moderate pace over coming quarters." This suggests that the economy would have to exhibit far more weakness than the Fed currently expects for them to lower rates at the May meeting. The Fed is likely to hold rates steady longer than the street expects.

ECONOMY

When Chairman Behrnanke testified before the House and Senate Banking Committee on February 14, he forecast that GDP growth in 2007 would be 2.5% to 3%, "with growth strengthening somewhat as the drag from housing diminishes." The recent sub-prime mortgage problem will likely result in slower growth in this year's first half. In addition, the sizeable run up in gasoline prices caused a large drop in the ABC Money Poll's Consumer Comfort Index in March, *matching the index's worst drop in its 21 year history*. The biggest drops in optimism were among households with incomes of \$40,000 - \$100,000. However, as long as the Fed expects the economy to weather these problems and still manage to strengthen before year end, they are not going to lower rates at the first signs of slowing.

As I noted in January's newsletter, a recent research report by the Fed's staff indicates that U.S. labor force growth will slow in coming years, since the proportion of women who choose to work has peaked, and as baby boomers retire. An estimated 80 million baby boomers will reach retirement age over the next decade, 45% of the work force. A .2% slowdown in labor force growth means it would only take an increase of 100,000 to 110,000 jobs per month, rather than 140,000 new jobs, to keep the Unemployment Rate steady. As I noted last month, for the first time since 2000, Unit Labor costs rose more than Productivity. The Unemployment Rate ticked

The Financial Commentator

Newsletter – March 25, 2007

down to 4.5% in February, and Average Hourly Earnings were up 4.1% over the past year. When the FOMC says in both the January and March post meetings statement, “The high level of resource utilization has the potential to sustain inflation pressures”, I think they have good reason to mean it.

As I wrote last month, “The economy wasn’t as strong as reported in the fourth quarter, since it was goosed by some statistical abnormalities in the initial estimate of GDP.” The Commerce Department subsequently revised their initial 3.5% estimate of fourth quarter GDP down to 2.2%. The economy entered the first quarter not as strong as expected, and the sub-prime problem and spurt in gasoline prices surely hasn’t helped growth in the first quarter. More companies are likely to acknowledge the tougher economic environment in the first quarter when they release their results in April, and guide investor’s expectations lower going forward. The Unemployment Rate will rise in coming months, but since the Fed remains concerned about the high level of resource utilization in the labor market, they won’t lower rates immediately. It is important to remember the Fed wants the economy to slow and to see some slack build in the labor market. As I wrote last November, “Unless the economy slows far more than the Fed expects, they will be in no hurry to lower rates. Lowering rates too soon would risk establishing a higher trough for core inflation that the Fed has repeatedly said *could prove costly to reverse.*”

The next six months are going to be very challenging for the members of the Federal Reserve, as they try to balance many conflicting factors. I don’t envy the responsibility they shoulder. Until the Fed’s forecast for strengthening in the second half of this year is truly called into question, I think the Fed will hold policy steady.

SUB-PRIME MORTGAGE WOES

An intense debate is raging on whether the woes in the sub-prime mortgage market will spread to other areas of mortgage lending. As far as I’m concerned, it already has spread in one important way – lending standards. As I mentioned last month, a January survey by the Fed found that more institutions had increased lending standards than at any time since 1991. Let’s think about what that means in the real world. Even though the Fed has kept rates unchanged for months, ***monetary policy has been effectively tightened by many lending institutions.*** This is just the opposite of what was happening as the Fed was increasing the Federal Funds rate from 1.0% to 5.25%. The drag effect of those increases did not fully impact the economy, since many mortgage lenders continued to offer consumers mortgage rates of 1% to 2%. The pendulum has now swung the other way. However, ***lending standards are not just being raised for sub-prime borrowers, but for borrowers across the board.***

In the long run, this is healthy, since making mortgage loans without income verification and allowing inflated appraisals to be the norm is not sound. However, in the short run, higher lending standards will curb demand, even as foreclosures increase. ***It is hard to believe that less demand***

The Financial Commentator

Newsletter – March 25, 2007

and more supply will not depress home values more than we've already seen. When the Fed does lower rates, the higher lending standards will still be maintained for some extended time. The Fed will only lower rates, if the expected late 2007 rebound in the economy looks doubtful, or the housing market weakens sharply. If the economy warrants Fed easing, mortgage payment delinquencies and foreclosures will be rising. That is not an environment conducive to lowering lending standards, and lending institutions won't. This means the drag on the economy from tighter lending standards will continue even after the Fed lowers rates. This also means the stimulus normally provided the economy from rate reductions will not completely pass through to consumers. Just as mortgage lenders negated the drag from higher rates between 2004 and 2006, they will limit the beneficial effects of lower rates, just as the economy will need them the most.

In the early 1990's, as the savings and loan crisis deepened, Federal Reserve Chairman Greenspan said it represented a substantial headwind for the economy. About half of all savings and loans went out of business. Between 1986 and 1995, the solution to the S&L crisis cost the U.S. taxpayer \$153 billion. Besides the funding authorized by the government for the Resolution Trust company to buy insolvent S&L's, the Federal Reserve also implemented a monetary policy to aid the rest of industry. By lowering short-term rates to 3%, S&L's and banks could pay certificate of deposits 3%, while earning 4.5% to 6.5% in short-term Treasury bonds. This dramatically widened profit margins, and made it possible for many sick S&L's to get healthy over time.

It is no one's best interest for the sub-prime lending problem to become a crisis that contributes to a sharp decline in home values in a short period of time. The Federal Reserve may not *target* asset prices as they formulate monetary policy, but they certainly are not oblivious to the growing economic role asset prices have played in the last 10 years. Would economic growth have been as strong over the last ten years, had stock prices not run up so much, or the boost consumer spending received from the hundreds of billions in *annual* home equity extraction? ***In 2005 and 2006, the amount of home equity extraction exceeded the entire increase in disposable income for each year.*** The Fed may say they don't target asset prices, but reality says they can't afford not to.

I'm confident that the Fed appreciates the potential risk, from the rising tide of adjustable rate mortgages taken on during the last 3 years. Since delinquency rates and foreclosure rates will continue to increase for sub-prime mortgages in coming months, accompanied by a rise in non sub-prime mortgages too, the level of risk for the markets and the economy from this problem will also increase. To put it simply, it is way too early to think the worst is already behind us.

It is no coincidence that the S&L crisis in the early 1990's, that Greenspan described as a 50-mph headwind for our economy, was deepened by a slow down in real estate activity and a decline in home prices on both coasts. The current problem with sub-prime loans, and the general deflating of housing activity, is certainly a headwind for our economy that is going to last for longer than we would prefer. As noted previously, half of the S&L's in this country were wiped out the last

The Financial Commentator

Newsletter – March 25, 2007

time real estate ‘corrected’. A lot people had their homes foreclosed on them. Even though the problem was ‘managed’, there was enough pain to go around, and it cost \$153 billion. So even if the current real estate contraction doesn’t spin out of control, and is ‘managed’ reasonably well as I think likely, it still could contain a mini-crisis that would be unpleasant.

The Fed thought that the *home owners equivalent rent* component of the Consumer Core Rate of inflation would decline as home values softened, and help lower the core CPI in the process. This hasn’t happened yet because only recently has the year over year value of homes turned negative. In many areas, the cost of renting a home is far less than buying one, so the dip in home values hasn’t filtered through. In the early 1990’s, the Federal Reserve lowered rates to help save half of the S&L industry. It would obviously help many of those whose mortgage payment is going to rise by 30%, 50% or 70% per month in the next year, (and some of the financial institutions holding these mortgages), if the Federal Funds rate was lower than it is today. I suspect that the *owners equivalent rent component* of the core CPI will start to come down in the next 3 to 6 months. Should we question the timing of this fortunate ‘coincidence’, or merely be grateful? Hopefully, core inflation rates will moderate and make it easier for the Fed to lower rates, ***before economic weakness out weighs inflation as the predominant policy concern***. Keep your fingers crossed.

STOCKS

The stock market is also facing a number of headwinds. If the economy has slowed as much as I think, corporate earnings are likely to be OK for the first quarter, but they will be lower than in previous quarters. More companies are also likely to lower their guidance for coming quarters, which the market probably won’t like. The fallout from the current ‘correction’ in real estate is going to get worse. I just don’t know whether it happens during the next month or so, or later this year in the fall. However, the chart of Japanese Yen suggests that the recent rally in the Yen, which began in February, will likely carry the Yen up to 90.00 - 91.00. The initial phase of this Yen rally certainly contributed the stock market sell off in late February and early March. The market also declined in May and June of 2006, when the Yen rallied from 84.00 to 92.00. If the Yen rallies as I expect, the market will experience another selling wave.

In each of the stock market corrections since 2004, the market has declined into an initial low, rallied, and then dropped below the initial low. Given this pattern, the odds favor another decline that pulls the S&P below its early March low. Technically, the decline from the highs in February occurred on a huge increase in volume. This suggests that there is more selling to come. I think the S&P will drop below 1364, and could potentially test the high from May of last year near 1325.

The Financial Commentator

Newsletter – March 25, 2007

BONDS

For months I have felt that the 10-year Treasury yield was locked in a trading range between 4.6% and 4.9%. The basic strategy was to sell bonds when yields dipped under 4.6%, and buy when they reached 4.8% to 4.9%, since I didn't think the Fed was going to lower rates. Although the Fed won't lower rates as soon as many expect, the slowing in the economy should be supportive of the Treasury bond market. I doubt we'll see yields above 4.8%. In other words, I would recommit or add to Treasury bond positions, if yields reach 4.75% to 4.8%. If the economy slows down to a range of 1.5% to 2.5% as I have expected, the spread between Treasury yields and corporate bonds should widen.

DOLLAR

As I noted last month, if the economy slowed as I expected, "things could get a little trickier." I felt the Dollar had to hold above 83.17 (March 07), if the Dollar was going to rally to 86.75 (March 07). It didn't hold 83.17. It now appears likely that the Dollar will test its late 2004 low, just under 81.00 (June 07). I expect that test to be successful, and lead to another rally attempt. This analysis dovetails with the expected rally in the Yen. It would be longer-term bearish for the Dollar, if the Yen pushes above 92.00.

GOLD

I continue to believe that the correction which began last June in Gold has not completed. The price pattern suggests that another decline below \$600 will be needed. However, this will be called into question if Gold runs much past \$710. The short-term timing model on the XAU did turn up on March 19, when the XAU was 134.99. If Gold does approach \$600, the XAU should trade under 120.00. This would represent a great buying opportunity, since I expect the XAU to trade above 170 over the next year.

E. James Welsh